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No. 95-1319

# In the Supreme Court of the United States

OCTOBER TERM, 1995

HUGHES & LUCE, L.L.P.,
ALAN J. BOGDANOW, TAX MATTERS PARTNER,
PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

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12 pp

## QUESTION PRESENTED

Whether the tax benefit rule requires a taxpayer who erroneously claimed deductions for loans in years closed by the statute of limitations to include repayments of those loans in its gross income in the year of repayment.

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App A1-A15) is reported at 70 F.3d 16. The opinion of the Tax Court (Pet. App. B1-B18) is reported at 68 T.C.M. (CCH) 1169.

### JURISDICTION

The judgment of the court of appeals was entered on November 15, 1995. The petition for a writ of certiorari was filed on February 13, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. Petitioner is a law firm. From its inception in 1976 through 1989, petitioner claimed deductions for expenses it paid on behalf of clients, including court filing fees, expert witness fees, travel and meal expenses, long-distance telephone charges, and delivery services (Pet. App. A2-A3). When its clients later repaid petitioner for these expenditures, petitioner included the repayments in its gross income (*id.* at A3).

In 1992, the Commissioner of Internal Revenue began an audit of petitioner's income tax return for its taxable year 1989. The Commissioner determined that the payment of client expenses by petitioner represented loans to, or advances on behalf of, the clients. As the result, the Commissioner concluded that petitioner is not to deduct the amounts that it expends on behalf of its clients and, upon repayment of such advances, is not to include such payments as income (Pet. App. A4).

On its return for 1989, petitioner had claimed deductions totalling $2,367,535 for expenses paid on behalf of its clients and had included in its income reimbursements from its clients totalling $2,398,825. Of this latter amount, $1,908,509 was attributable to the reimbursement of amounts paid and deducted in 1989. The remainder of $490,766 was attributable to the reimbursement of amounts paid and deducted by petitioner in years prior to 1989 (Pet. App. A4-A5 & n.2). Petitioner accepted, for purposes of this case, the Commissioner's characterization of its payments on behalf of its clients as nondeductible loans.

Petitioner maintained, however, that, in light of the Commissioner's determination that the payments

made on behalf of its clients were loans, petitioner should be entitled to exclude from its income for 1989 the entire amount of the reimbursements it received from its clients in that year, including the reimbursement of amounts paid and deducted in years prior to 1989. The Commissioner determined, however, that, because $490,766 of the reimbursements received by petitioner in 1989 represented amounts that petitioner had erroneously deducted in years prior to 1989, and because the statute of limitations precluded any adjustment to those prior years, petitioner was required under the tax benefit rule or, alternatively, under the duty of consistency doctrine to include in its income for 1989 $490,766 of the reimbursements that petitioner received from its clients in that year.

2. Petitioner sought review of the Commissioner's determinations in Tax Court. The court rejected the contention that the tax benefit rule required the reimbursed costs of $490,766 to be included in petitioner's 1989 gross income.[1] The court reasoned that the tax benefit rule applies only when the original deduction was proper when taken, which was not the case here (Pet. App. B10). The court went on to hold, however, that petitioner was required to include the amount in issue in its gross income for 1989 under the

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[1] Under the tax benefit rule, when an amount deducted in a prior year is recovered in a later year, or an event occurs in a later year that is inconsistent with the premise on which the deduction was based, the taxpayer must include the amount in its income for the later year to the extent the prior deduction resulted in a tax benefit. See *Hillsboro National Bank* v. *Commissioner*, 460 U.S. 370, 383-384 (1983).

doctrine of quasi-estoppel known as the duty of consistency (*id.* at B12-B17).[2]

3 The court of appeals affirmed on the ground that the tax benefit rule required petitioner to include the reimbursed costs in its 1989 gross income (Pet. App. A1-A15). The court of appeals rejected the Tax Court's "erroneous deduction exception" to the ordinary application of the tax benefit rule (*id.* at A9-A11). The court noted that the "erroneous deduction exception" that the Tax Court applies to the tax benefit rule "has been criticized or rejected by many Courts of Appeals" (*id.* at A9). The court noted that application of the tax benefit rule in this case does not vitiate the statute of limitations because it does not reopen a closed tax year; the only taxable year implicated by operation of the rule is 1989, the year the reimbursed costs were received, which is an open year (*id.* at A11). Because the court of appeals con-

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[2] As a general rule, the duty of consistency applies when (i) the taxpayer makes a representation on his return in one year, (ii) the Internal Revenue Service acquiesces in that representation, (iii) the taxpayer seeks to change that representation in a later year, after the statute of limitations has expired on the year of representation, and (iv) the change is detrimental to the Internal Revenue Service. *E.g.*, *Lewis* v. *Commissioner*, 18 F.3d 20, 25-26 (1st Cir. 1994); *Herrington* v. *Commissioner*, 854 F.2d 755, 758 (5th Cir. 1988), cert. denied, 490 U.S. 1065 (5th Cir. 1989). The Tax Court reasoned that, because petitioner reported the out-of-pocket costs as deductible expenses and the reimbursement of those costs as income in years prior to 1989, and because the Internal Revenue Service acquiesced in that treatment, petitioner could not, after the statute of limitations on those earlier years expired, change its treatment of the costs to the detriment of the Internal Revenue Service by failing to treat the reimbursed costs as income (Pet. App. B12-B17).

cluded that the Commissioner properly applied the tax benefit rule in this case, the court found it unnecessary to decide whether "this same result is [also] required under the duty of consistency" (*id.* at A14).

## ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. The tax benefit rule is designed to alleviate some of the distortions of income that arise from the annual tax accounting system. *Hillsboro National Bank* v. *Commissioner*, 460 U.S. 370, 377-380 (1983). For example, a taxpayer may claim a bad debt deduction under Section 166 of the Internal Revenue Code, 26 U.S.C. 166, only to recoup the debt in a later year upon his debtor's unexpected financial recovery. Repayment of the debt is a return of capital and therefore would not normally be includible in gross income. 460 U.S. at 377. The tax benefit rule, however, requires the recovered amount to be included in gross income in the year of recovery to the extent the bad debt deduction resulted in a tax benefit in the prior year. *Id.* at 377-378. See Boris Bittker & Stephen Kanner, *The Tax Benefit Rule*, 26 UCLA L. Rev. 265 (1978). The tax benefit rule applies not only when a taxpayer recovers an amount deducted in a prior year but also when an event occurring in a later year is "fundamentally inconsistent" with the premise on which the deduction in the earlier year was based. *Hillsboro National Bank* v. *Commissioner*, 460 U.S. at 383-384.

In this case, although the Tax Court reasoned that the tax benefit rule should apply only when the initial deduction was proper when claimed, the court of appeals correctly rejected this "erroneous deduction exception" to the tax benefit rule (Pet. App. A9-A11). As the courts of appeals have consistently concluded, the tax benefit rule properly applies whenever there is a later recovery of amounts previously deducted, regardless whether the prior deduction was proper or improper when claimed. See *ibid.*; *Unvert* v. *Commissioner*, 656 F.2d 483, 485-486 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982). See also *Union Trust Co.* v. *Commissioner*, 111 F.2d 60, 61 (7th Cir.), cert. denied, 311 U.S. 658 (1940).

2. Petitioner erroneously contends (Pet. 10) that the decision in this case conflicts with *Northwestern States Portland Cement Co.* v. *Huston*, 126 F.2d 196 (8th Cir. 1942). The *Northwestern States* case did not involve the tax benefit rule; and the Eighth Circuit's opinion in that case did not even discuss the tax benefit rule, much less adopt the so-called "erroneous deduction exception" to the rule.

The taxpayer in *Northwestern States* had set up a reserve account on its books to reflect its contingent liability to repurchase cloth sacks used in its cement manufacturing business. In 1916 and 1917, the taxpayer decreased its capital surplus account and increased its reserve account by a like amount, and then deducted the additions to the reserve account from its gross income. By 1932, having concluded that its contingent liability had diminished, the taxpayer made a bookkeeping transfer of $75,000 from its reserve account back to the capital surplus account. The Commissioner sought to include the reduction in this reserve account in the taxpayer's gross income

for 1932. The Eighth Circuit, however, reasoned that "[b]ookkeeping entries do not produce either income or losses for the purposes of taxation" (126 F.2d at 199) and held that the additions to reserve were not deductible when made and that the later additions to surplus were not to be included in income (*ibid.*).

*Northwestern States* has never been cited—other than by petitioner—as adopting or supporting an "erroneous deduction exception" to the tax benefit rule. Indeed, even petitioner did not cite that case for such a proposition in its briefs in the courts below. The Eighth Circuit has not regarded its decision in *Northwestern States* as establishing any limitation in the application of the tax benefit rule. See *Austin* v. *Loftsgaarden*, 768 F.2d 949, 955-956 (8th Cir. 1985) (en banc), rev'd on other grounds *sub nom. Randall* v. *Loftsgaarden*, 478 U.S. 647 (1986); *Crystal Lake Cemetery Ass'n* v. *United States*, 413 F.2d 617, 622 (8th Cir. 1969); *Reynolds* v. *Boos*, 188 F.2d 322, 325-326 (8th Cir. 1951). And, it is doubtful that the reasoning employed in the 1942 decision in *Northwestern States* has any continuing validity, even in the Eighth Circuit. See *James M. Pierce Corp.* v. *Commissioner*, 326 F.2d 67, 70 (8th Cir. 1964) (citing with approval cases holding that where a taxpayer accumulates deposits paid by its customers in a reserve account, and in a later year transfers unclaimed deposits to a surplus account, the taxpayer has taxable income in the year the transfers are made).

3. Petitioner errs in asserting (Pet. 16) that the decision in this case conflicts with the decision of this Court in *Hillsboro National Bank* v. *Commissioner*, *supra*. In *Hillsboro*, the Court did not address the validity of an "erroneous deduction exception" to the tax benefit rule. The question addressed in *Hillsboro*

was whether the tax benefit rule applies only when the taxpayer actually *recovers* an amount previously deducted or whether it also applies when an event in a later year is inconsistent with the premise on which the deduction was claimed. 460 U.S. at 381-383. The Court held that the rule applies if a later event is "fundamentally inconsistent with the premise on which the deduction was initially based." *Id.* at 383. In so holding, the Court in no way indicated that the actual recovery of an amount previously deducted would not implicate the tax benefit rule where the prior deduction was erroneous.[3]

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[3] Moreover, even if the tax benefit rule were not applicable in this case, the Tax Court correctly held that the Commissioner's determination of petitioner's tax liability is independently supported by the doctrine of quasi-estoppel known as the duty of consistency (Pet. App. B17). See *Lewis* v. *Commissioner*, 18 F.3d at 25-26; *Herrington* v. *Commissioner*, 854 F.2d at 758.